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SUBJECT: FINANCE MINISTER BAR-ON SHOCKED AT FAYYAD OECD LETTER

Classified By: Ambassador Richard H. Jones for reasons 1.4 b and d.

Summary

11. (C) In a June 5 meeting between Ministry of Finance (MOF) DG Yarom Ariav, his Senior Advisor Michal Finkelstein, and the Ambassador, Ariav said that Finance Minister Bar-On was "shocked" that Palestinian Prime Minister Fayyad had sent a letter seeking to block Israeli accession to the OECD. The letter disrupted the Minister's trip to Paris to discuss OECD issues and will result in a tougher Israeli approach to the transfer of customs revenue. The MOF will not deliberately delay the transfers, but will pay more careful attention to the payment of outstanding Palestinian debts, particularly to the Israel Electric Corporation. Ariav gave no exact date for when the current month's revenues would be transferred, but assured the Ambassador that it would be within a few days. On other Palestinian-related issues, Ariav indicated that the final status economic talks were progressing and that there is agreement on the notion of two independent states and two independent economies. The readout Ariav received from the Bethlehem Investment Conference was positive, but only time will tell if it results in concrete achievements. Ariav noted that one issue of critical importance for the Palestinian Authority (PA) economy is the development of a mortgage system to facilitate housing construction.

12. (C) Summary Continued. On the Israeli economy and budget situation, Ariav lamented that the present political uncertainty is allowing for the proposal of numerous bills in the Knesset which might have negative budgetary consequences. However, with the support of the Prime Minister, the MOF plans to maintain the present fiscal parameters for 2009 -- a one percent deficit ceiling and a 1.7 percent expenditure growth ceiling -- and will officially inform the USG of this decision next week in its response to the May 9 letter to Ariav from the Departments of State and Treasury. Finkelstein said that the MOF also plans to develop a longer-term fiscal formula, tied to Israel's debt-to-GDP ratio, to govern fiscal decision-making in future years. While noting that the Israeli economy is still doing remarkably well, Ariav said that the continued strong shekel will inevitably harm Israeli exports. End Summary.

Bar-On Shocked by Fayyad OECD Letter

13. (C) Ariav told the Ambassador that Finance Minister Bar-On was "shocked" by the letter sent by Palestinian Prime Minister Fayyad urging that Israel's OECD accession be blocked due to its policies vis-a-vis the Palestinians. He

said that he and the Minister would never have expected Fayyad to send such a letter. Moreover, the timing could not have been worse, with Bar-On finding out about it just as he was leaving for Paris to negotiate OECD accession issues. Instead, dealing with the fallout from the letter has become a main focus of the trip, diverting the Minister from his mission. As a consequence, Ariav said that "if this is the Palestinian approach," there will now be a new Israeli approach as well. He noted that outstanding PA debts to Israeli institutions did not hold up revenue transfers by Israel in the past. While the revenue transfers will not be slowed down deliberately, they will be subjected to greater scrutiny, and Israel will no longer be so flexible regarding outstanding PA debts, such as those owed to the Israel Electric Corporation. Without being specific, Ariav added that this type of PA approach "won't help in other areas either."

Revenue Transfer in a Few Days

¶4. (C) The Ambassador said that the letter had surprised the U.S. too. He noted that Fayyad had expressed regret for sending the letter and said that he believes that the Palestinian PM understands that it was a mistake. He noted that the MOF has always been at the forefront of Israeli government ministries in its willingness to cooperate with the PA. He further referred to the extremely fragile state of the Palestinian economy and the importance of timely revenue transfers to its ability to continue to function. Ariav said that he understands the difficult PA economic

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situation, but that the MOF approach regarding outstanding debts will be tougher from now on, adding that "the letter caused problems for Israel, but won't help the Palestinians." In any case, he said that he expected the present month's revenue transfer to take place "in a few days," but did not give a specific date.

Two States Two Economies

¶5. (C) Regarding other Palestinian-related issues, Ariav said that he is heading the team discussing final status economic issues, and that there is agreement about the goal of establishing two independent states with economies independent of one another. The negotiations are dealing with detailed issues such as the type of trade regime that will be established between the two states. On the Joint Economic Committee, Ariav said that its work continues productively. The last meeting was held just a few days ago.

Palestinians Need Mortgage Concept

¶6. (C) Regarding the Bethlehem Conference, he said that the jury is still out as to its effectiveness. He and his office were not represented at the conference, but he received a report from Amos Shapira of the Israel Palestinian Business Council, who said that many business cards were exchanged and that a great deal of money was pledged for investment projects. What is not clear is whether this is new money, or already-pledged donor money repackaged for the occasion. He noted that investment in housing and construction projects is critical for the Palestinian economy, as is the development of a mortgage market to facilitate it. However, he said, the concept of a mortgage is not well-accepted or understood in the Arab world. The Ambassador agreed, saying that, in his experience, progress on building projects throughout the Middle East is generally tied to the amount of cash on hand. He added, however, that there has been some recent success in

Iraq in introducing the concept of a mortgage, which might bode well for similar efforts in the West Bank.

Economy Doing Well -- But For How Long?

¶17. (C) On the economic front, Ariav said that dealing with the Knesset lately has not been easy, due to the political instability resulting from the Olmert corruption investigation. Numerous pieces of legislation have been introduced that could have negative budgetary consequences. If a 2009 budget is not passed before the end of the year, the 2008 budget will continue to apply, with one twelfth of its total spent each month in 2009 until a new budget is passed. The Ambassador remarked that this at least has the virtue of maintaining fiscal discipline in an unstable political environment. Ariav agreed, but noted that the lack of a budget would harm the MOF's long-term planning process. While the economy is now performing remarkably well, it is not clear how long that will continue. The chief concern is the strength of the shekel, which will eventually hurt Israeli exports. Meanwhile, unemployment is down and labor participation is up, with 49,000 individuals joining the work force in the first quarter of 2008 alone.

JEDG Parameters to Stay the Same in 2009

¶18. (C) The Ambassador raised the May 9 letter sent to Ariav by the Departments of State and Treasury regarding the formulation of the Joint Economic Development Group's (JEDG) Loan Guarantee Agreement parameters for the 2009 budget, and asked when a response would be forthcoming. Ariav replied that he expected the MOF response to be ready next week. The MOF will propose maintaining the current parameters for 2009 -- a one percent deficit ceiling, a 1.7 percent expenditure increase ceiling, and continued reforms in a variety of areas. He said that this would undoubtedly generate a major debate in the government. However, he noted that Prime Minister Olmert assured him personally of his support for the MOF position.

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Long-Term Fiscal Formula Needed

¶19. (C) For the period beyond 2009, the MOF's goal is to establish a fiscal formula tied to the debt to GDP ratio to govern expenditure and deficit decisions. Israel's debt to GDP ratio, as high as 160 percent in the 1980s and 104 percent in 2003, is now down to below 80 percent, still high when compared to the OECD average of about 58 percent. Ariav said that his goal is for Israel to reach the OECD average by ¶2015. He believes this is possible, barring a deep depression striking the economy. Continued weakness in the dollar would also help Israel reach this goal, as a quarter of Israel's debt is external and denominated in dollars, whereas the debt-to-GDP ratio is calculated using shekel balances. He repeated that a continued weak dollar would, however, have other negative consequences, such as a general slowdown in Israeli exports, a major sector of the economy.

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JONES